Statement by Governor - Sixth Bi-monthly Monetary Policy Statement, 2019-20, February 6, 2020

Over the last three days, *i.e.*, during 4th, 5th and 6th February, 2020 the Monetary Policy Committee (MPC) met and assessed current and evolving macroeconomic and financial conditions and the outlook. After extensive and drill-down review and discussions, the MPC voted unanimously to keep the policy rate unchanged. It also decided to continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

2. While this decision may be on expected lines and perhaps widely discounted, it is important not to discount the RBI! It has to be kept in mind that the central bank has several instruments at its command that it can deploy to address the challenges that the Indian economy currently faces in terms of the sluggishness in the growth momentum. Consequently, even though the present monetary policy decision is constrained by elevated inflation pressures, there are other ways in which the RBI can strive to revive growth. I know I have whetted your curiosity, but first let me briefly explain the main considerations underlying the MPC's decision.

3. At this stage, I would like to express my gratitude to the MPC members for their insights and careful evaluation, which shaped the policy decisions. The MPC's Resolution has just been released on the RBI's website.

4. I also want to thank our teams in the RBI for their continued high-quality support to the MPC's work through their hard work, research and logistics.

5. The MPC noted that since its meeting in early December 2019, global economic activity remains subdued; however, some variations in macroeconomic performance are becoming evident among major economies. In the US, the pace of growth has been broadly maintained in the second half of 2019; but in the euro area, the UK and Japan, economic activity has slowed down in Q4. Among emerging market economies (EMEs), the Chinese

economy decelerated to a 29-year low in 2019, while a loss of momentum was manifest in Russia, Brazil and South Africa. Crude oil prices have softened from mid-January with a sharp fall towards the end of the month, triggered by the outbreak of the coronavirus. With international food prices rising on higher demand and supply disruptions, inflation has edged up in some major AEs and EMEs. Global financial markets remained resilient in December 2019 and January 2020 as thawing US-China trade relations and improved prospects of an orderly Brexit buoyed investors' sentiments.

6. Turning to the Indian economy, the first advance estimates (FAE) released by the National Statistical Office (NSO) on January 7, 2020 placed India's real gross domestic product (GDP) growth for 2019-20 at 5.0 per cent. In terms of high frequency indicators, both production and imports of capital goods – two key pointers of investment activity – continued to contract in November and December. Government expenditure, especially of the Centre, is providing counter-cyclical support to domestic demand.

7. On the supply side, *rabi* sowing has been higher by 9.5 per cent up to January 31, 2020 compared with a year ago, and horticulture production is estimated to have risen by 0.8 per cent to a record level in 2019-20. Industrial activity improved in November after contracting in the previous three months. The output of core industries returned to positive territory in December after four months of contraction, which augurs well for the December 2019 industrial production print. Capacity utilisation (CU) in the manufacturing sector, however, fell in Q2:2019-20 even on a seasonally adjusted basis. The manufacturing sector faced weak demand conditions in Q3:2019-20, though business sentiment is improving. This is corroborated by the manufacturing purchasing managers' index (PMI) which picked up sharply in January 2020 on the back of increased output and new orders. In the services sector, several high frequency indicators have turned upwards in the recent period, such as tractor sales (representing rural demand), domestic air passenger traffic (an indicator of urban demand), three-wheeler sales, railway freight and port traffic. The PMI

services index also improved sharply in January 2020, boosted by a rise in new business and output. On the other hand, passenger vehicle sales contracted in December.

8. Retail inflation, measured by the CPI, surged to 7.4 per cent in December, the highest reading since July 2014. Food inflation rose to double digits, primarily caused by a spike in onion prices due to unseasonal rains in October-November (excluding onions, headline inflation would have been 5.2 per cent). Prices of several other food sub-groups such as milk, pulses, cereals, edible oils, eggs, meat and fish also firmed up. Fuel prices moved out of deflation. Inflation in CPI excluding food and fuel (or core inflation) continued to edge up from its October trough.

9. In the external sector, merchandise export growth continued to contract in November-December 2019, reflecting the slowdown in global trade. Import growth slumped further in November-December 2019, reflecting the underlying weakness in domestic demand. Net foreign direct investment, however, rose to US$ 24.4 billion in April-November 2019 from US$ 21.2 billion a year ago. Net foreign portfolio investment was of the order of US$ 8.6 billion in 2019-20 (up to February 4) as against net outflows of US$ 14.2 billion in the same period last year. In addition, net investments by FPIs under the voluntary retention route have aggregated US$ 7.8 billion since March 11, 2019. External commercial borrowings were higher at US$ 13.4 billion during April-December 2019 as compared with US$ 2.5 billion during the same period a year ago. India's foreign exchange reserves were at US$ 471.4 billion on February 4, 2020 – an increase of US$ 58.5 billion over end-March 2019.

10. Taking into consideration these factors, the MPC revised the CPI inflation projection upwards to 6.5 per cent for Q4:2019-20; 5.4-5.0 per cent for H1:2020-21; and 3.2 per cent for Q3:2020-21, with risks broadly balanced. It also projected GDP growth for 2020-21 at 6.0 per cent – in the range of 5.5-6.0 per cent in H1 and 6.2 per cent in Q3. While doing so, the MPC noted that inflation has surged above the upper tolerance band around the target in December

2019. Over the coming weeks and months, onion prices are likely to ebb as supply conditions improve but this could be tempered by hardening of prices of other food items, notably those of pulses and proteins, and adjustments to telecom charges. Accordingly, the MPC will remain vigilant about the potential generalisation of inflationary pressures. At the same time, the economy remains weak and the output gap is negative. Financial flows to the commercial sector have improved in recent months. The Union Budget 2020-21 has introduced several measures to provide an impetus to growth, including the emphasis on boosting the rural economy and infrastructure, income tax rate readjustments, GST rate reductions and the corporate tax rate cuts of September 2019. Given the evolving growth-inflation dynamic, the MPC felt it appropriate to maintain *status quo* on the policy repo rate but resolved to continue with the accommodative stance as long as necessary to revive growth, while ensuring that inflation remains within the target. The MPC also recognised that there is monetary policy space for future action.

11. I want to use the backdrop of the MPC's deliberations to explain how the RBI envisages the impact of the monetary policy decision on reviving growth while ensuing price stability. It is necessary to recognise that the transmission of policy rate reductions has been sizable across various money and bond market segments. As against the cumulative reduction in the policy repo rate by 135 bps since February 2019, transmission to various money and corporate debt market segments ranged from 146 bps (overnight call money market) to 190 bps (3-month CPs of non-banking finance companies). Transmission through the longer end of government securities market was at 73 bps (5-year government securities) and 76 bps (10-year government securities).

12. Moreover, transmission to the credit market is gradually improving. The 1-year median marginal cost of funds-based lending rate (MCLR) has declined by 55 bps during February 2019 and January 2020. The weighted average lending rate (WALR) on fresh rupee loans sanctioned by banks has declined by 69 bps and the WALR on outstanding rupee loans by 13 bps during February-

December 2019. The external benchmark system introduced from October 1, 2019 has strengthened monetary transmission further. Most banks have linked their lending rates for housing, personal and micro and small enterprises (MSEs) to the policy repo rate of the Reserve Bank. During October-December 2019, the WALRs of domestic banks (public and private sector) on fresh rupee loans declined by 18 bps for housing loans, 87 bps for vehicle loans and 23 bps for loans to micro, small and medium enterprises (MSMEs). These developments should amplify the effects of the cumulative policy rate reductions since February 2019 and help boost domestic demand going forward.

13. Underlying the decline in GDP growth in 2019-20 is a deceleration in private consumption, stagnation in investment and contraction in both exports and imports under the impact of the slowdown in global growth and trade. Looking ahead, the pick-up in GDP growth in 2020-21 is likely to be led by private consumption, which should benefit from higher spending power on account of the reduction in GST rates and income tax rate reductions for middle-income slabs. Rural incomes would be supported by the expected bumper *rabi* production and the recent improvement in terms of trade for the farm sector on account of higher food prices. The outlook for investment is also showing signs of improvement. The corporate tax regime brought in from September 2019 should improve the competitiveness of Indian businesses. There is some evidence from unaudited balance sheets of listed firms that the corporate tax cut has bolstered their retained earnings which, in turn, is being ploughed back into creation of fixed assets rather than into financial investments or cash holdings. Furthermore, the Union Budget envisages that capital outlay excluding defence would expand by 26.2 per cent, which could crowd in private investment. Overall, gross fixed investment could rise and propel domestic demand, income and employment. Sectors that could benefit from the Union Budget's capex commitments are power, cement, aviation and transport, and roads. The RBI will continue to be watchful of how these growth potentials actually play out.

14. Turning to inflation, the main driver of the recent surge has been onion and other vegetable prices, as explained earlier. Softening of onion prices has already commenced with arrivals of the late *kharif* crop. As regards prices of other vegetables, the usual winter softening has been delayed but potato prices have started to ease and prices of other vegetables may soften over the coming weeks. Cereal prices may also soften if destocking sales are undertaken in order to accommodate procurement of the bumper *rabi* crop. On the other hand, the staggered revisions of milk prices may have a more lasting influence on headline inflation. Prices of pulses are firm but they may remain range-bound on pro-active supply management measures by the Government. Overall, the greatly improved prospects for the *rabi* harvest augur well for food prices in the summer of 2020. One-off cost push increases in respect of mobile telephone charges and prices of essential medicines are likely to push up CPI inflation excluding food and fuel and the possible spillovers will need careful monitoring. The projections indicate that inflation pressures could ebb in the second half of 2020-21 and ease below the target in Q4.

15. Meanwhile, downside risks to global growth have increased in the context of the outbreak of the coronavirus, the full effects of which are still uncertain and unfolding. A well executed contingency plan may, however, minimise the negative impact of this headwind.

16. Barring the intensification of global risks, I would like to emphasise that there is policy space available for future action. This space needs to be used appropriately and should be suitably timed to optimise its impact on growth. Although monetary policy action is constrained at this juncture by the inflation outlook, these pressures should ease going forward. In such a situation, the RBI has several other instruments to address the challenges to growth by improving monetary transmission as well as by incentivising the flow of bank credit to productive sectors of the economy. The policy initiatives announced under developmental and regulatory measures address these objectives, thereby amplifying the intent of monetary policy to support growth, while

ensuring that inflation remains within the target. Needless to add that the aspect of financial stability is always kept in mind while designing any new regulatory measure.

17. Thus the developmental and regulatory policy measures seek to facilitate credit flows to certain sectors, reinforce monetary transmission, strengthen regulation and supervision, broaden and deepen financial markets and improve the payment and settlement systems.

Revised Liquidity Framework

18. As announced in the Statement on Developmental and Regulatory Policies of June 6, 2019, an Internal Working Group was set up to review the liquidity management framework. Based on the feedback received on the draft report from stakeholders and members of the public, the liquidity management framework is being revised. The framework is simplified by doing away with targeted provisions linked to net demand and time liabilities (NDTL). Multiple operations for multiple tenors would be replaced by one fortnightly operation at the beginning of the reporting fortnight, followed by fine-tuning operations every day, as required. Liquidity operations shall ensure adequate provision of liquidity to the banking system. The corridor system remains unchanged, and the call money rate continues to be the operating target of liquidity operations. Finally, the revised framework introduces longer term liquidity management instruments to manage durable liquidity.

Long Term Repo Operations (LTROs)

19. Since June 2019, the Reserve Bank has ensured that comfortable liquidity is available in the system to facilitate the transmission of monetary policy actions. With a view to assuring banks about the availability of durable liquidity at reasonable cost relative to prevailing market conditions and to further encourage banks to undertake maturity transformation smoothly and seamlessly so as to augment credit flows to productive sectors, the Reserve Bank shall conduct term repos of one-year and three-year tenors in appropriate

sizes for up to a total amount of ₹1,00,000 crore from the fortnight beginning on February 15, 2020 at the policy rate.

Incentivising Bank Credit to Specific Productive Sectors

20. Alongside sustained efforts to improve monetary transmission, the Reserve Bank is actively engaged in revitalizing the flow of bank credit to productive sectors having multiplier effects to support impulses of growth. Accordingly, scheduled commercial banks will be allowed to deduct the equivalent of incremental credit disbursed by them as retail loans for automobiles, residential housing and loans to micro, small and medium enterprises (MSMEs), over and above the outstanding level of credit to these segments as at the end of the fortnight ending on January 31, 2020 from their net demand and time liabilities (NDTL) for maintenance of cash reserve ratio (CRR). This exemption will be available for incremental credit extended up to the fortnight ending on July 31, 2020.

External Benchmarking of New Floating Rate Loans by Banks to Medium Enterprises

21. Drawing upon the experience of linking all new floating rate personal or retail loans and floating rate loans to micro and small enterprises (MSEs) to external benchmarks, the pricing of loans by scheduled commercial banks for medium enterprises is also being linked to an external benchmark effective April 1, 2020.

Extension of One-time Restructuring Scheme for MSME advances

22. In order to create an enabling environment for the micro, small and medium enterprises (MSME) sector in its efforts towards increased formalisation and to facilitate them to tide over this transition, the Reserve Bank has decided to extend the benefit of one time restructuring without an asset classification downgrade to GST registered MSME accounts that were in default but standard as on January 1, 2020. The restructuring under the scheme has to be implemented latest by December 31, 2020. Incidentally, the theme of this

year’s financial literacy week has been selected as “Micro, Small and Medium Enterprises (MSMEs),” which will be observed from February 10 to February 14, 2020.

Guidelines on Projects under implementation in Commercial Real Estate sector

23. Complementing the initiatives taken by the Government of India in the real estate sector, the reserve bank has decided to permit extension of the date of commencement of commercial operations (DCCO) of project loans for commercial real estate, delayed for reasons beyond the control of promoters, by another one year without downgrading the asset classification in line with the treatment accorded to other project loans for the non-infrastructure sector.

Regional Rural Banks - Permission for Merchant Acquiring Business

24. To give a fillip to digital banking and to enable RRBs to provide cost effective and user-friendly solutions to their customers, Regional Rural Banks (RRBs) are being allowed, like other commercial banks, to act as merchant acquiring banks using Aadhaar Pay – BHIM app and POS terminals.

Financial Markets

25. With regard to financial markets, transparency of the rupee interest rate derivative (IRD) market is sought to be enhanced by proposing that all rupee IRD transactions of market makers and their related entities globally shall be accounted for in India. This measure would, in addition, encourage non-resident participation, enhance the role of domestic market makers in the offshore market, and strengthen regulatory oversight.

26. The introduction of legislation for netting of financial transactions, proposed in the Union Budget 2020-21, would be a significant enabler for efficient margining. A proper margining system would enhance credibility of the market mechanism and discourage excessive risk-taking. Accordingly,

directions are being issued regarding exchange of variation margin (VM) for non-centrally cleared derivatives (NCCDs) by end-March 2020.

Payment and Settlement System

27. Measures in the payment and settlement space include (a) construction and dissemination of a composite “Digital Payments Index” (DPI) to capture the extent of digitisation of payments; (b) a framework for a Self-Regulatory Organisation (SRO) for orderly operations of the entities in the digital payment system; and (c) expanding the reach of cheque truncation system (CTS) pan-India.

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